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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 666

MRS. EDNA BRITT, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The letter opinion of the district court (R. 68–70),[1] and the findings of fact and conclusions of law of the district court (R. 70–72) are not reported. The opinion of the court of appeals (Pet. A15–A23) is reported at 335 F. 2d 907.

JURISDICTION

The judgment of the court of appeals (Pet. A25) was entered August 12, 1964. The petition for a writ of certiorari was filed November 9, 1964. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

[1] Record references herein are to the printed record before the court of appeals.

QUESTION PRESENTED

Whether a cash basis taxpayer is currently taxable on that part of fully earned brokerage fees due him for obtaining loans for customers which has been used to satisfy his contractual obligation to post security (cash or securities) with the lender in connection with his guaranteeing the repayment of the loans.

STATUTE INVOLVED

Internal Revenue Code of 1954:

> SEC. 61. GROSS INCOME DEFINED.
>
> (a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
>
> * * * * *
>
> (2) Gross income derived from business;
>
> * * * * *
>
> (12) Income from discharge of indebtedness;
>
> * * * * *
>
> (26 U.S.C. 1958 ed., Sec. 61.)

STATEMENT

The opinion of the court below (Pet. A15–A23) sets forth the agreed facts (Pet. 4–5) in brief compass. The taxpayer was a Mississippi broker of small loans who reported his income on a cash basis. In 1958, he entered into a contract with Hall Brothers Company, a lending institution (hereafter "the lender") under which he agreed, *inter alia,* to guarantee all loans made by the lender to his clients, and as security for

that guaranty, to keep on deposit with the lender an amount equal to 25 per cent of the loans outstanding to his clients. The taxpayer could provide this fund in either of two ways: he could deposit the amount with the lender, or he could, as provided by the contract, "deposit with the lender three per cent (3%) of the amount of each draft drawn by the Broker on the Lender on behalf of the Broker's customers, which said three per cent (3%) shall be deposited in the guaranty funds * * *, and shall be so paid by the Broker as each draft is drawn on the Lender."

The taxpayer's business was conducted in the following manner. A prospective borrower went to the taxpayer's office, filled out a loan application and signed a note agreeing to repay the loan plus interest and plus the taxpayer's brokerage fee. The taxpayer then forwarded the application to the lender, together with a statement of the amount applied for. If the lender approved the loan, the taxpayer was authorized to draw a draft on the lender for the amount of the loan less discount (interest) and the 3% for the reserve. The taxpayer then gave the borrower the amount of the draft less the service fee. As illustrative of such a transaction, the court below suggested the following example (Pet. A16–A17, fn. 1).

> Assume the borrower wishes to secure through such procedures $300 to be repaid in one year. The applicable law permits the lender to charge six per cent per annum; service charges and interest combined cannot exceed

"two per cent of the amount of cash received by the borrower multiplied by the number of months for which the loan is extended". The interest and the broker's service charge combined in this case may equal $72, 2% of $300 times 12. This would make a total of $372. Interest on this sum at six percent would be $22.32. Deducting this from $72 (the total allowable interest and service charge) would leave the allowable charge $49.68. The three per cent reserve would be $10.49. The amount of the loan would include both interest and service fee $72. Lender would retain his interest ($22.32) and the reserve ($10.49) and the broker would thus draw a draft for the $300 for his customer plus the balance of his service fee ($49.68 less $10.49) or $339.19, handing $300 of this to the borrower.

On his 1958 tax return the taxpayer deducted losses of $14,817.09 and also a "lender's reserve" of $4,608.58. (R. 43.) The latter amount was disallowed as an unauthorized deduction (R. 52), presumably because Section 166 of the Revenue Code allows a deduction for actual bad debt losses or a reserve, but not both.[2] The taxpayer paid the result-

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[2] Section 166, in relevant part, reads as follows:

SEC. 166. BAD DEBTS.

(a) *General Rule.*—

(1) *Wholly worthless debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

* * * * *

(c) *Reserve for Bad Debts.*—In lieu of any deduction under subsection (a), there shall be al-

ing deficiency and the petitioner, his widow, brought suit for a refund, claiming that the reserve was not includable in income since it could not be withdrawn. (R. 4.) The district court so held (R. 68–73) but was reversed on appeal. The court below held that under the taxpayer's contractual arrangements and applicable Mississippi statutes governing small loans, the brokerage fee was a charge payable by the borrower, earned by the broker when the loan was placed, and "received" by the taxpayer here when applied in satisfaction of his contractual obligation to post security for his guarantee to the lender.

ARGUMENT

The decision below correctly applied well-settled principles of tax law to the undisputed facts of the case. There is no conflict and no occasion for further review by this Court.

1. The taxpayer-broker became entitled to a service fee from the borrower the moment each loan was approved by the lender. The amount of that fee was included in the net loan which the borrower was required to repay to the lender and upon which he paid interest. The taxpayer, who acted as an intermediary in conveying the proceeds of the loan from the lender to the borrower, withheld from the borrower the full amount of the service fee, taking the major part of it in cash and permitting the balance to be credited to

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lowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

his account in the guaranty fund, in satisfaction of his independent[3] contractual obligation to the lender. In these circumstances, it is clear, we submit, that the taxpayer received the full economic benefit of the entire brokerage commission and therefore, under well-settled principles, is taxable upon the whole of it.[4]

In terms of the illustration given by the court below (*supra*, p. 4), the net effect of the transaction is precisely the same as if lender had transmitted the net

[3] The taxpayer's obligation under his contract with the lender was separate and distinct from particular loan transactions. In the first place, as we have noted, the taxpayer was not required to deposit a portion of his brokerage fee as such, but was free to deposit cash or securities from any source whatever. And while the contract provided that the timing of those deposits could be geared to the particular loan transactions, the taxpayer would presumably have been free to deposit the full 25% in a single lump sum payment.

This is not a case, moreover, in which the broker put up his commission as security for the repayment of the particular loan which generated that commission. In such a case it might be argued that the commission has not been "earned" until the loan is repaid. Here, however, the sums deposited in the guaranty fund will remain there as security for future loans long after all of the loans which gave rise to those deposits have been repaid. It is possible, for example, that after 100 transactions, the guarantee fund will have attained its prescribed level of 25% of outstanding loans. Barring defaults, and assuming the rate of retirements equals the rate of new loans, no further deposits need be made. Even after the first 100 loans have been repaid, the deposits made at the time of those loans will be retained by the lender as security for the broker's guarantee obligation on later transactions in which no deposits were made.

[4] *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716; *Rayberson-Manhattan Co.* v. *United States*, 296 U.S. 60; *Helvering* v. *Horst*, 311 U.S. 112, 116.

loan of $349.69 (*i.e.*, the gross note minus the lender's discount) directly to the borrower, the borrower had paid the taxpayer the full brokerage fee of $49.69, and the taxpayer had then deposited the required amount, $10.49, in the guaranty fund. Had the payments been routed in that manner, no one would question that the taxpayer had received the full amount of the service fee and was taxable on it. The result would be no different if the borrower, instead of paying the entire service fee to the taxpayer, directed part of it ($10.49) to the lender with instructions that it be credited to the taxpayer's account in the reserve fund. *Old 'Colony Trust Co.* v. *Commissioner,* 279 U.S. 716. Here the proceeds of the loan reached the borrower by way of the taxpayer as intermediary. Again, however, if the lender had delivered to the taxpayer the full amount of the loan, taxpayer had withheld the full brokerage fee before handing over the balance in cash to the borrower, and then had deposited the appropriate amount in the guaranty fund, his taxability on the amount so deposited would be patent. The result should plainly be no different merely because the taxpayer elected to have the lender retain the deposit in the first instance and to reduce correspondingly the amount of the draft drawn on the lender.

Taxpayer argues that, since he is on the cash basis, he ought not be taxed on that portion of his service fee which was "retained" by the lender. That contention erroneously assumes that it was the lender who owed the brokerage commission. As the court

below noted, however, it is quite clear, both under the Mississippi small loan statute and under the agreement between taxpayer and the lender here, that the brokerage fee is an obligation of the borrower, not the lender. The borrower fully discharged that obligation at the time of the transaction; for while he wrote a note for, and paid the maximum legal interest on, a gross sum ($372) which included the service fee ($49.68) and lender's discount ($22.32), he actually received in cash a much smaller amount ($300), permitting the service fee to be withheld, in part by the taxpayer-broker himself, and in part by the lender to satisfy the taxpayer's deposit obligation. In other words, the service fee was paid in full by the borrower and either received by the taxpayer or applied for his benefit.

2. The taxpayer's argument fails to distinguish between two quite different situations. If, on the one hand, A owes B a sum of money for services rendered and defers payment until some future date, B is not taxable at that point unless he is on the accrual basis. On the other hand, if A, instead of withholding the money, pays it to C in order to discharge B's contractual obligation to C, B has a constructive receipt and is immediately taxable even if he is on the cash basis. *Old Colony Trust Co.* v. *Commissioner,* 279 U.S. 716; *Helvering* v. *Horst,* 311 U.S. 112. Taxpayer treats the present case as though it belonged to the first category, with the lender cast in the role of "A" and the taxpayer-broker as "B." Actually, as we have shown, this three-cornered transaction is

of the second type; it is the borrower who is "A", and the lender's only relationship to the service fee is that of the third-party creditor, "C", to whom a portion of the fee is paid for B's (the taxpayer's) benefit.

This analysis points up the distinction between the present case and *Commissioner* v. *Hansen,* 360 U.S. 446, upon which taxpayer chiefly relies. There, the taxpayer, an automobile dealer, sold negotiable installment paper to a finance company, which remitted to the dealer the major part of the purchase price, but withheld the balance as security for the dealer's guarantee of the installment obligations. Thus, the transaction in *Hansen,* unlike the one involved here, conformed to the first, rather than the second, of the two models contrasted above, for the amount withheld constituted the unpaid portion of a sum owed to the taxpayer by the withholding party itself (the finance company, or "A").

3. The court of appeals decisions cited by the taxpayer are inapposite. *Wilkins Pontiac* v. *Commissioner,* 298 F. 2d 893 (C.A. 9); *Foster Frosty Foods, Inc.* v. *Commissioner,* 332 F. 2d 230 (C.A. 10). Accord, *Family Budget Service, Inc.* v. *United States,* (S.D. Miss.), decided November 20, 1963 (13 A.F.T.R. 2d 465). Those cases involved the question whether additions to bad debt reserves were deductible by an accrual basis taxpayer as business expenses, where the reserves were an offset to the taxpayer's purely contingent liabilities as guarantor. In the instant case the amount credited to the taxpayer's guaranty fund

by the lender during 1958 was claimed by the taxpayer as a business expense deduction, and was disallowed by the Internal Revenue Service on the ground that there was no statutory ground for the deduction. However, petitioner's refund claim was based upon the ground that the amounts in question were not includible in the income of a cash basis taxpayer, and the present litigation has been limited to that issue.

We note, moreover, that the taxpayer could in no event have reasonably claimed a deduction for additions to the guaranty fund on the theory that it was a "bad debt reserve," since he also claimed and was allowed a deduction of $14,817.09 for "losses paid"; no taxpayer may deduct both the additions to a bad debt reserve and the bad debt losses themselves as defaults occur.

CONCLUSION

For the reasons stated, we respectfully submit that the petition for certiorari should be denied.

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